R800.8
R229ta

REAL
ESTATE
CENTER
Solutions Through Research

Texas A&M University
College Station, Texas
77843-2115
409-845-2031

Technical Report

Real Estate and the 1990 Tax Act

Jerrold J. Stern
Research Fellow

and

Associate Professor of Accounting
Graduate School of Business
Indiana University

Government Publications
Texas State Documents
JUL 22 1991
Depository
Dallas Public Library

May 1991

Real Estate Center

Director

Dr. Richard L. Floyd

The Real Estate Center was created in 1971 by the Texas Legislature and placed at Texas A&M University.

The Center conducts a comprehensive program of research and education to meet the needs of many audiences, including the real estate industry, instructors and the general public.

A catalog describing hundreds of publications and computer programs is free for the asking. Write the Real Estate Center, Texas A&M University, College Station, Texas 77843-2115 or telephone 409-845-2031.

Advisory Committee

William C. Jennings, Sr., Fort Worth, chairman; Patsy Bohannan, The Woodlands; Don Ellis, Del Rio; Alberto R. Gonzales, Houston; Fred McClure, Washington, DC; Richard S. Seline, Washington, DC; David L. Stirton, Houston; Jack W. Tumlinson, Cameron; Thomas A. Wilder, North Richland Hills; and Henry Santamaria, El Paso, ex-officio representing the Texas Real Estate Commission.

Solutions Through Research

Contents

Summary

This report summarizes major provisions of the Revenue Reconciliation Act of 1990 that affect real estate. Highlights include the following:

- While the top individual marginal tax rate has dropped to 31 percent from 33 percent, real estate investors and others may be paying **effective** tax rates of 35 percent or higher.
- The top long-term capital gains tax rate has officially dropped to 28 percent from 33 percent. However, **effective** tax rates on capital gains may exceed 32 percent.
- Individuals subject to the alternative minimum tax will pay a rate of 24 percent, up from 21 percent.
- Low-income rental housing tax credits for investors have been increased, and there is an opportunity to accelerate credits from future years into 1990.
- Tax credits up to $5,000 now are available for costs incurred in providing the disabled access to businesses.
- Penalties of $25,000 to $100,000 may be imposed on taxpayers who intentionally disregard reporting requirements concerning the receipt of more than $10,000 in connection with a business transaction.
- Tax credits of up to $2,000 of the principal residence mortgage interest for certain low-income homebuyers have been extended.
- Self-employed individuals (such as real estate brokers) may continue to deduct 25 percent of health insurance costs regardless of whether or not they itemize deductions.

Tax Rates, Deductions and Capital Gains

Several of the 1990 tax act's provisions are related, simultaneously affecting both an investor's tax liability and **effective** tax rate on additional income. The effective tax rate on additional income is the increase in tax divided by the additional income. Thus, if $10,000 of additional income results in a $3,500 tax increase, the effective tax rate on that income is 35 percent.

The interrelated new rules affect the tax rate structure, exemptions, itemized deductions and the capital gains tax.

Individual Tax Rate Structure

Prior to the tax act, the order of marginal tax rates for individuals was 15, 28, 33 and 28 percent. The 33 percent bracket was called the "bubble" bracket because it phased out at high incomes and caused a taxpayer's marginal tax rate to fall to 28 percent. For 1990, the 33 percent bracket begins at $78,400 for married couples filing jointly, $67,200 for heads of households, $47,050 for singles and $39,200 for married couples filing separately.

For 1991, the new law introduces tax rate schedules that **appear** to be more straightforward (see appendix). Marginal tax rates are now 15, 28 and 31 percent. The 31 percent bracket does **not** phase out and begins at $82,150 for married couples filing jointly, $70,450 for heads of households, $49,300 for singles and $41,075 for married couples filing separately. All brackets will be adjusted for inflation beginning in 1992.

While the new 31 percent top bracket is lower than the previous 33 percent "bubble" bracket, some taxpayers still will pay federal income tax at an **effective** rate of 33 percent or higher on some of their income. The higher effective rate is created by an interaction between the rate schedule and other tax calculations.

Personal and Dependency Exemptions

The personal and dependency exemption for 1990 was $2,050. The 1991 exemption is $2,150. Thus, total exemptions for a 1991 joint tax return filed by a married couple with two dependent children are $8,600 ($2,150 per person).

One reason a taxpayer's effective tax rate can exceed 31 percent under the new law is the phase-out of personal exemptions for high-income taxpayers. **Exemptions are phased out by 2 percentage points for each $2,500 ($1,250 for married couples filing separately) or fraction thereof by which a taxpayer's adjusted gross income (AGI) exceeds the applicable "threshold." The thresholds, which will be adjusted annually for inflation, are $150,000 for joint returns, $125,000 for heads of households, $100,000 for singles and $75,000 for married couples filing separately.** This provision is effective through 1995.

For example, assume a husband and wife have combined salary income of $201,000 and four exemptions totalling $8,600 (including two for dependent children). If there is no other income, the exemptions are reduced to $4,988, or $8,600 less 42 percent. The 42 percent is computed as follows:

[($201,000 AGI - $150,000 threshold)/$2,500]
rounded up x 2

Based on the phaseout rule, exemptions are eliminated once AGI reaches $122,501 **more than** the threshold amount. In this example, once AGI reaches $272,501 (or $122,501 above the $150,000 threshold), exemptions are eliminated. These phaseout calculations raise the couple's effective tax rate on some of their income to **more than** 31 percent. An example illustrating this phenomenon follows.

Itemized Deductions

The most common itemized deductions are home mortgage interest, property taxes and charitable contributions. Another common category is **miscellaneous** deductions, which includes unreimbursed employee business expenses and tax return preparation fees. The total of miscellaneous deductions is reduced by 2 percent of AGI, and any amount remaining is included in the total of all itemized deductions.

Taxpayers whose total itemized deductions exceed their "standard deduction" list these deductions on Schedule A of Form 1040. Then, the total is subtracted in computing taxable income. Standard deductions for 1991 are $5,700 for joint returns, $5,000 for heads of household, $3,400 for singles and $2,850 for married couples filing separately.

For 1991 through 1995, the new law reduces itemized deductions for taxpayers whose AGI exceeds a certain threshold—$100,000 for joint returns, heads of households and singles; $50,000 for married couples filing separately. Like the phaseout of exemptions, this new itemized deduction calculation will result in higher effective tax rates for some taxpayers.

First, the computation requires the total itemized deductions to be split into two parts. Part One comprises three less common itemized deductions—medical expenses, casualty and theft losses, and investment interest (interest paid on loans used to acquire investment property). Part Two is simply the total of all remaining itemized deductions (including miscellaneous deductions exceeding 2 percent of AGI).

The reduction of itemized deductions is 3 percent of AGI more than the threshold. However, the reduction cannot exceed 80 percent of the Part Two itemized deductions. Part One itemized deductions never are reduced.

For example, assume a married couple has $300,000 of AGI, $10,000 of Part One itemized deductions and $25,000 of Part Two itemized deductions. AGI more than the threshold is $200,000 ($300,000 less $100,000) and 3 percent is $6,000. Thus, the couple's deductible itemized deductions become $29,000 ($10,000 Part One plus $25,000 Part Two, reduced by $6,000).

If Part Two deductions were only $7,000, the reduction would be limited to $5,600 (80 percent of $7,000), not $6,000. The couple's deductible itemized deductions would be $11,400 ($10,000 Part One plus $7,000 Part Two reduced by $5,600). Significantly, the 80 percent rule only will benefit taxpayers who have relatively low amounts of itemized deductions.

Capital Gains

Starting in 1991, the maximum tax rate applied to long-term capital gains by the tax rate schedule is 28 percent. However, **effective** tax rates on capital gains will exceed 28 percent for taxpayers affected by exemption and itemized deduction phaseouts discussed above. The comprehensive example in the next section illustrates this phenomenon.

Long-term capital gains result from the sale of capital assets held more than one year. Common capital assets are stocks, bonds and real estate held solely for investment purposes. Gains from the sale of real estate used in a trade or business for more than one year typically are taxed exactly as though they are long-term capital gains.

Example of Effective Tax Rates

Effective tax rates under the new law will be higher than the rates shown in the tax rate schedule for high-income taxpayers. This is because of the phaseout of exemptions and itemized

Computation of Effective Tax Rate

	Base Case		Add $10,000 Income	
Adjusted gross income		$176,000		$10,000
Itemized deductions:				
Total	$ 17,000			
Reduction:				
3% x ($176,000-$100,000)	2,280	14,720		300
Exemptions:				
AGI	176,000			
Threshold	150,000			
Excess	$ 26,000		10,000	
Excess/$2,500, rounded up	11		4	
Multiply by 2 percent	22%		8%	
Reduction:				
6 exemptions x $2,150 x ___%	2,838		1,032	1,032
Exemptions after reduction:				
(6 x $2,150) - $2,838	10,062	10,062		
Taxable income		$151,218		$11,332
Additional tax caused by $10,000 income:				
$11,332 x 31%				$ 3,513
Effective tax rate on $10,000 income:				35%
Additional tax	$ 3,513			
Additional income	$ 10,000			

deductions. The table illustrates how effective tax rates are computed.

The example in the table assumes a joint tax return is filed by a married couple with four dependent children (six exemptions). The "Base Case" columns in the table indicate itemized deductions are reduced because AGI exceeds the $100,000 threshold (following the computations discussed and illustrated). Itemized deductions are assumed to consist mainly of mortgage interest, property taxes and charitable contributions. Thus, the 80 percent rule has no effect on the calculations. Exemptions are reduced because AGI exceeds the $150,000 exemption threshold. Calculations follow the same pattern explained and illustrated previously.

Effective Tax Rate on Additional $10,000

The table columns labeled "Add $10,000 Income" demonstrate how an investor's effective tax rate can rise to more than the 31 percent top tax bracket. An additional $10,000 of income increases the **reduction** of itemized deductions by 3 percent of $10,000, or $300, because AGI is already more than the $100,000 threshold. Thus, an additional $300 of AGI (over and above the $10,000 of new income) is subjected to tax.

A similar result occurs with exemptions. The table shows how the added $10,000 AGI increases the percentage reduction of exemptions by 8 percentage points, thereby reducing deductible exemptions by an additional $1,032 (six exemptions x $2,150 x 8 percent). The $1,032 reduction of exemptions causes $1,032 more of AGI to be subject to tax.

Even though AGI increased by $10,000, taxable income increased by $11,332 because of additional phaseouts of itemized deductions and exemptions caused by the $10,000 rise in AGI. The couple is in the 31 percent tax bracket, yet the 31 percent rate is applied to the entire $11,332 increase in taxable income, not just the $10,000 increase in AGI. As a result, the effective tax rate for the $10,000 additional income is 35 percent, as shown in the table.

Can effective tax rates rise to more than 35 percent? Unfortunately, the answer is *yes*. The phaseout of itemized deductions adds approximately 1 percentage point to a high-income taxpayer's effective tax rate (3 percent x 31 percent = .93 percent). Further, a high-income taxpayer's effective tax rate increases by approximately .5 percentage points for **each** exemption—thus, more exemptions create a higher effective tax rate. These approximations correspond to the 35 percent effective tax rate shown in the table, as follows:

31 percent tax bracket rate
1 percent for phaseout of itemized deductions
3 percent for phaseout of exemptions (6 x .5 percent)

35 percent effective tax rate on additional income

Effective Tax Rate on Capital Gain Income

The calculations in the table assume the $10,000 additional income is "ordinary income," such as salary, commissions, royalties, bonuses, dividends and interest. Recall the tax act provides for a maximum tax rate of 28 percent on long-term capital gains. However, if the $10,000 in the table were long-term capital gain income rather than ordinary income, the **effective** rate would be 32 percent (not 28 percent), computed as follows:

28 percent "maximum" tax bracket rate
1 percent for phaseout of itemized deductions
3 percent for phaseout of exemptions (6 x .5 percent)

32 percent effective tax rate on capital gain income

As just shown, the 28 percent maximum long-term capital gain tax rate applies only to gain itself, not to the extra taxable income created by phaseouts of itemized deductions and exemptions. Note the difference between the two effective tax rates is 3 percentage points (35 percent based on ordinary income versus 32 percent based on capital gain income). This 3 percentage point spread can be considered a "constant" difference between the effective tax rates of ordinary and long-term capital gain income **for high-income taxpayers.** Thus, it once again makes a difference whether income is ordinary or capital gain.

Alternative Minimum Tax

The alternative minimum tax (AMT) is intended to increase the tax liability of taxpayers who receive large benefits from certain "tax preference" provisions in the law. These provisions include rapid depreciation, incentive stock options, and deductions such as property taxes and miscellaneous itemized deductions. Prior to the act, the AMT tax rate for individuals was 21 percent (20 percent for corporations). **The new law raises the rate to 24 percent for all taxpayers.**

Taxpayers who benefit from tax preferences, such as those previously noted, are required to compute two tax liabilities—one using the regular tax method (partially illustrated by the table) and the other using the AMT method. Briefly, the AMT method includes virtually all of the income of the regular method plus tax preferences and certain other adjustments. In essence, the taxpayer must pay the higher of the two tax liabilities.

The increase in the AMT rate undoubtedly will cause more taxpayers to be subject to the AMT than under prior law. **Thus, there is now a greater need to include the effects of the AMT in tax planning and investment analyses.**

Low-Income Rental Housing Credit

Tax credits of various amounts are allowed for qualified low-income housing construction, rehabilitation or acquisition. Credits are received in annual installments over ten years. Each state receives an annual credit limit, which was $1.25 per state resident prior to 1990 and $.9375 per state resident for 1990. **To receive a credit, the property owner must receive a credit allocation from the Texas Housing Agency located in Austin.**

The new law extends the credits through 1991 and restores the per-resident limit to $1.25. In addition, investors owning low-income property on October 26, 1990, may make a one-time election to accelerate future credits to the 1990 tax year by increasing their 1990 credit by 50 percent. For example, if an investor's 1990 credit is $10,000 without the election, the 1990 credit could be increased to $15,000. Assuming the investor has five years of credit eligibility remaining after 1990, the allowable credit for each future year would be reduced by $1,000 ($5,000 spread equally over five years).

Tax Credit for Cost of Providing Access to the Disabled

A new tax credit is available to encourage eligible small businesses to remove architectural and other physical barriers that prevent access by the disabled. The credit is 50 percent of "eligible access expenditures" more than $250, up to a maximum credit of $5,000 (50 percent of expenditures of $10,250 after subtracting a $250 floor amount). Thus, a business receiving a $5,000 credit could reduce its tax bill dollar-for-dollar by $5,000.

For this credit, a *small business* is defined as a sole proprietorship, partnership or corporation satisfying **either** of the following conditions during the preceding year:

- gross receipts were not more than $1 million
- there were no more than 30 full-time employees

Expenses incurred in connection with new construction are not eligible for the credit. Moreover, eligible expenditures must be reasonable and the removal of barriers must meet the standards of the Architectural and Transportation Barriers Compliance Board as well as forthcoming Treasury regulations.

Under prior law, businesses of any size could deduct up to $35,000 for removal of architectural and transportation barriers to the handicapped and elderly. The maximum for this deduction is reduced to $15,000 under the new law. **Taxpayers cannot take advantage of both the deduction and the credit for the same expenditures.** Furthermore, any amounts taken either as a credit or a deduction cannot also be added to the tax basis of the real estate for tax depreciation purposes; there is no opportunity for double tax benefits.

Reporting Requirements for Receipts Exceeding $10,000

Businesses receiving more than $10,000 in "cash" in connection with a single transaction (or two or more related transactions) **must file an information return** with the IRS. The term "cash" does not include personal checks. However, in a transaction of $10,000 or more, "cash" does include foreign currency and, starting in 1991, also includes any "monetary instrument" (whether or not in bearer form) with a face value of $10,000 or less. An expanded definition of "monetary instruments" will be given by the Treasury Department in late 1991. Officials at the accounting firm of Price Waterhouse expect the definition to include travelers checks, bank drafts, cashiers checks and money orders.

The 1990 act increased the penalty for intentional disregard of these reporting requirements. This penalty is now the greater of $25,000 or the amount of cash received up to $100,000.

Mortgage Revenue Bonds and Mortgage Credit Certificates

Law prior to the 1990 act allows state and local governments to issue tax-exempt bonds (mortgage revenue bonds) if the proceeds are used to provide mortgages for owner-occupied homes. Mortgage recipients must meet certain income, purchase price and other criteria. State and local governments also have the authority to issue mortgage credit certificates. The certificates enable homebuyers to tax credits up to 50 percent of the mortgage interest on their principal residence. A maximum tax credit of $2,000 per year is allowed. The same income and purchase price criteria mentioned above also apply to credit certificates.

The 1990 act extends the mortgage revenue bond and mortgage credit certificate provisions through the end of 1991. Also, recapture rules are modified slightly. They require a percentage of the subsidy to be paid to the IRS if the home is sold within nine years. Thus, homeowners benefitting from the tax credit must pay part of it back if they sell their home during the first nine years.

Health Insurance Costs of the Self-Employed

Individuals who are considered self-employed for tax purposes (such as most real estate brokers) may deduct 25 percent of health insurance costs regardless of whether they itemize their deductions. This provision was scheduled to expire as of October 1, 1990. The new law extends the deduction through 1991.

This report is for information only. For specific advice, consultation with a tax advisor is recommended.

591–450–863

Appendix

1991 Tax Rate Schedules for Individuals

Married Couple Filing Jointly

If taxable income is: more than	but not more than	Regular income tax liability before credits is			of the amount more than
$ 0	$34,000	$ 0.00	+	15%	$ 0
34,000	82,150	5,100.00	+	28%	34,000
82,150	-	18,582.00	+	31%	82,150

Head of Household

If taxable income is: more than	but not more than	Regular income tax liability before credits is			of the amount more than
$ 0	$27,300	$ 0.00	+	15%	$ 0
27,300	70,450	4,095.00	+	28%	27,300
70,450	-	16,177.00	+	31%	70,450

Single

If taxable income is: more than	but not more than	Regular income tax liability before credits is			of the amount more than
$ 0	$20,350	$ 0.00	+	15%	$ 0
20,350	49,300	3,052.50	+	28%	20,350
49,300	-	11,158.50	+	31%	49,300

Married Couple Filing Separately

If taxable income is: more than	but not more than	Regular income tax liability before credits is			of the amount more than
$ 0	$17,000	$ 0.00	+	15%	$ 0
17,000	41,075	2,550.00	+	28%	17,000
41,075	-	9,291.00	+	31%	41,075

Reprint Policy

Reprint Policy

The Real Estate Center has no objection to others reprinting all or part of this publication providing these guidelines are followed:

- The author is given full credit,
- The Real Estate Center is cited as the original publisher of this material,
- Reprints are not resold for profit,
- No substantive additions or deletions are made in the copy and
- Two copies of the reprint are sent to the Senior Editor:

Real Estate Center
Texas A&M University
College Station, Texas 77843-2115
(Telephone 409-845-2031)

Views expressed herein are those of the authors. Publication of these views does not imply endorsement by the Real Estate Center, the College of Business or Texas A&M University.

This publication was funded by appropriations to the Real Estate Center by the Texas Legislature.

Additional Copies

Requests for additional copies of this publication should be directed to the Publications Room at the address listed above.

Quantity Discounts

Discounts may be granted for quantity orders. Requests for such discounts should be made in writing to the Director, Real Estate Center. Such requests should state the quantity desired, purpose for which the item will be used and any other pertinent information that may assist in price determination. Instructors with special projects or unique requirements for multiple copies may receive special consideration. Such requests should be submitted in writing on college or university letterhead to the Center director.

Other Topics Available

Publications of the Real Estate Center are designed to meet the needs of many audiences, including the real estate industry, instructors and researchers and the general public. Several hundred publications are available from the Center on a wide range of topics. A copy of the Center catalog is available from the Center Publications Room.

Your Opinion *Please*

Thank you for ordering this publication from the Real Estate Center. To better serve you, we would appreciate your suggestions. Please take a few minutes to answer the following questions and return this postage-paid sheet to the Center.

1. Please evaluate each characteristic of this publication:

	Excellent	Good	Fair	Poor	No Opinion
overall content	☐	☐	☐	☐	☐
technical detail	☐	☐	☐	☐	☐
clarity	☐	☐	☐	☐	☐
organization	☐	☐	☐	☐	☐

2. To what degree did this publication meet your needs?

very useful 5 4 3 2 1 not useful at all

3. How did you hear about this publication? ____________________

____

4. What magazines or periodicals do you read most regularly to stay informed about real estate topics?

a) ____________________ b) ____________________

c) ____________________ d) ____________________

5. What other topics would you like to know about? ____________________

____

6. What is your principal occupation? ____________________

7. What real estate license do you hold? ☐ broker ☐ salesperson ☐ none

COMMENTS: ____________________

____

____

☐ Check to receive the Center's **FREE** catalog listing more than 300 publications, computer software and classroom teaching packets at nominal costs.

(please print)

Name ____________________

Address ____________________

City ____________________ **Zip** __________

TAPE HERE

FOLD

NO POSTAGE
NECESSARY
IF MAILED
IN THE
UNITED STATES

BUSINESS REPLY MAIL

FIRST CLASS PERMIT NO. 148 COLLEGE STATION, TEXAS 77843

POSTAGE WILL BE PAID BY ADDRESSEE

Real Estate Center
Texas A&M University
College Station, Texas 77843-9990

FOLD

No. 863